



**FPA**

FINANCIAL PLANNING  
ASSOCIATION  
of Australia Limited  
ABN 62 054 174 453

FINANCIAL PLANNING ASSOCIATION OF AUSTRALIA LIMITED  
(ACN 054 174 453)

## **POLICY POSITION**

### **Risk Tolerance**

EFFECTIVE DATE: OCTOBER 2003

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**1. *Disclaimer – Please Note***

- 1.1 Members of the Financial Planning Association of Australia Limited (“FPA”) are required to comply with the FPA’s Code of Ethics and Rules of Professional Conduct which are enforceable through FPA Disciplinary Procedures.
- 1.2 External Complaints resolution schemes can have regard to these professional standards when determining complaints against FPA Members.
- 1.3 The FPA also issues Policy Positions to educate members and raise awareness of the FPA position on particular financial planning issues, and to assist members in better servicing their clients. FPA takes care to ensure the information is accurate at the time of print but does not intend for Policy Position Papers to be prescriptive or mandatory.
- 1.4 Users should seek independent professional advice concerning their legal obligations and liabilities in relation to the matters discussed in Policy Position Papers and should not rely on Policy Position Papers alone.

**2. *Scope of this Policy Position***

- 2.1 Policy Position Papers are applicable to all FPA members being Principal Members, their Representatives, and individual Practitioner Members.
- 2.2 The FPA has a clear objective of establishing and maintaining high standards for the financial planning profession.
- 2.3 This Policy Position Paper intends to clarify the FPA Position on Risk Tolerance Assessment.

### 3. ***What is Risk***

3.1 Risk is defined within the Oxford Dictionary as the possibility of suffering loss and the exposure to such. The risk of any single investment is that its return will differ from its expected value.<sup>1</sup>

3.2 There are 'risks' inherent in all financial decisions. Investors need to have an appreciation of the risks they are taking so they can properly assess their financial planning options. **Investment risk** may flow from a number of sources, including but not limited to, capital value risks, default risks, inflation risks, income risks & liquidity risks.

3.3 An investor's tolerance to risk is the amount of volatility an investor is willing to endure in order to achieve their financial objectives. Factors affecting the investor may include their financial resources, existing liabilities, time horizons, and other obligations.

3.4 Apart from investment risk, investors are subject to **psychological risk**. Psychological risk refers to the level of volatility the investor is prepared to endure as a result of their personality, attitude, previous experience and other personal circumstances.

### 4. ***Financial Planner's Legal and Professional Obligations***

4.1 Risk Tolerance Assessment forms an important part of meeting legislative and common law <sup>2</sup> obligations. Section 945A (1) of Corporations Act 2001 requires financial planners to have a "reasonable basis" for advice. ASIC Policy Statement 175 (PS 175) Section C, "Preparing and Providing Suitable Advice" provides an outline of ASIC's interpretation of "suitability" or "reasonable basis for advice".

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<sup>1</sup> Tom Valentine "A critique of the ASIC/ FPA Approach to Risk in Investment" Undated.

<sup>2</sup> Paige v FPI Limited & Anor [2001] NSWSC 627: Financial planner who assumed responsibility for planning the whole of his clients' financial affairs & held himself out to do so, was found to have breached a duty of care as follows: in preparing a risk tolerance assessment he failed to adequately identify the clients' needs and risk profile or explain the process of risk evaluation to the clients, conduct his discussion with the clients in a manner that would have enabled him to adequately identify the clients' investment needs, adequately inform the clients so that they understood the nature and purpose of the information he obtained particularly as the conclusions were critical to the whole investment strategy; adequately identify the risks in the investments which he was recommending, and, competently advise the clients of the inherent risks, not only in the recommended investments, but also within & to other elements in the clients' financial arrangements in particular to the clients' capital; and, expressly warn the clients that the scheme might fail if the return from the investments could not be sustained.

4.2 In particular, paragraph 175.104 of ASIC PS 175 expressly specifies that where advice is related to financial products with an investment component, financial planners should determine their client's tolerance to risk in regard to their potential capital loss and also general tolerance that the investment strategy recommended will not produce the expected investment returns.

4.3 FPA Rules of Professional Conduct requires members to consider a client's tolerance to risk as an essential factor of formulating appropriate financial strategies and product recommendations. Rule 111 specifically states: "in preparing oral or written recommendations to clients a member shall provide an explanation of the nature of the investment risks involved in terms that the client is likely to understand".

## **5. *The Role of the Financial Planner***

### **5 A. *The Need To Disclose Risk to the Client***

1. Licensees have a duty to disclose risks as part of the general obligations of licensees to conduct business efficiently, honestly and fairly.
2. The Corporations Law as amended by the Financial Services Reform Act under sections 947B, C and D amongst other obligations specifies that certain relevant information must be disclosed within a Statement of Advice ("SOA"). A SOA must include a level of detail that a person would reasonably require for the purpose of making a decision about whether to act on the advice as a retail client. ASIC requirements with respect to the SOA are stipulated within section D of ASIC Policy Statement PS 175. In particular, PS 175.154(e) provides that an SOA must include information about the basis on which advice was given. Such information would reasonably include relevant information and conclusions obtained from taking risk tolerance into account. A SOA is required to be provided at the same time as, or in certain circumstances, as soon as practicably after, the advice is provided to the client.
3. The abovementioned legislation also requires that any information disclosed should be Clear, Concise and Effective.
4. FPA Rules of Professional Conduct supports the notion of clarity of disclosure as outlined in Rule 111.

5. Importantly, no two clients will necessarily have the same investment risk tolerance with respect to their financial strategy and it is the role of the financial planner to tailor the SOA for each client accordingly.
6. Members are encouraged to review and adopt 'Risk Disclosure Principles' contained in FPA Business Tool 2: Disclosure of Risk - Explaining the Relationship between Risk & Return.

**5 B. *The Need to Educate Clients on Risk***

1. As in most cases, the more knowledge and experience a person has, the less fearful they are of risk and more capable they are of making an informed decision. A financial planner's role is not to avoid investment risk altogether but to assist clients to learn to embrace and manage reasonable investment risks to achieve their desired investment goals over realistic and relevant time frames.
2. Financial planners are in the best position to explain and educate clients on the investment risks associated with the recommendations being made and the relationship of these investment risks to the client's risk tolerance assessment.
3. FPA emphasises that this educative relationship between the financial planner and the client is acknowledged at Common Law<sup>3</sup>.
4. A client's capacity and attitude to accept certain financial investment risks would normally be dealt with during the course of collecting sufficient information about the individual's personal circumstances. Important information of this nature will also be obtained during the educative process.

**5 C. *The Need to Communicate Risk to the Client***

1. There is no concrete evidence that any process or method can accurately predict a client's tolerance to investment risk.

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<sup>3</sup> Paige v FPI Limited & Anor [2001] NSWSC 627: Adviser found liable as a result of, inter alia, failing to advise the client that there were risks to his capital in the recommended investments. McClellan J noting at 198 that "a reasonable investigation would have ensured at the least that the clients were explained the elements of and practical application of their risk profile to the investments which he was recommending."

2. The FPA does not prescribe methods Financial Planners ought to use to determine the capacity of their clients to withstand less than expected investment performance. This is a matter of professional judgement.
3. Financial Planners would be expected to be able to advise clients about the range of outcomes they could reasonably expect to experience and to advise and discuss with clients, in terms they can easily understand, the financial implications of returns being at the bottom end of the possible range. For example, this may mean that retirement would need to be postponed for an extra year or lifestyle may need to be reduced in later years if they adopt the proposed strategy instead of opting for a risk free return such as an assumed cash return. It is also appropriate to consider the outcomes if normal market returns are experienced and even upside opportunity to allow clients to form a view about whether they value the potential benefits enough to justify the risk.
4. It should be noted that the range of outcomes upon which the Financial Planner would be expected to consider and advise upon is not limitless. Financial Planners should seek advice on their obligations concerning providing quality of advice in this respect. It should be noted that s945A(1) (b) of the Corporations Act 2001 provides that an adviser should "...having regard to the information obtained from the client about their relevant personal circumstances, give such consideration to, and conduct such investigation of, the subject matter of the advice as is reasonable in all the circumstances"
5. Information about the Investment Risk should be a feature of the SOA so clients can make an informed decision about their attitudes concerning the investment risk that is implicit in any recommendations.
6. An adviser's verbal communications with the client should reinforce the adviser's respective written communications to the client.
7. Financial Planners may also choose to assess and to employ methods for assessing each client's psychological tolerance to risk. The need to do so and the methods employed are a matter for professional judgement.

## 6. ***Best Practice Guidance on Risk Tolerance***

6.1 The capacity of individual clients to tolerate investment risk has two dimensions. The first is their financial capacity to tolerate poor investment performance over short and longer term periods compared to a risk free (cash) return. The second is their attitudes to implications that may arise from experiencing poor performance.

### ***Risk Profiling***

6.2 A common practice has been to classify clients into categories along a spectrum typically from “Conservative” to “Aggressive”. Advisers use a variety of techniques to make this appraisal. This process is generally used to identify risk preferences and sometimes referred to as “Risk Profiling”. The resulting categorization is used to determine the client’s investment Asset Allocation and often also individual stock selection.

6.3 Risk Profiling is not required in ASIC PS 175. Rather, the Policy Statement outlines a broader principle of Risk Tolerance, including both the risk of capital loss and the risk that the expected benefits will not be achieved.

6.4 After consultation, the FPA believes that “Risk Profiling” as described in 6.2 above, and resultant pigeon holing, are contrary to the concept of tailored and customised advice. It is yet to be proven that the processes used for categorising clients are robust and that short-term market performance or the current political and economic environment does not affect attitudes. Furthermore, a client’s actual circumstances and objectives may be in conflict with their expressed attitudes and preferences.

6.4.1 For example, an “aggressive” investor requiring all of their capital in the short term may be well advised to have a conservative portfolio despite their aggressive attitudes. Conversely, a client with a very long time frame would not be behaving aggressively by choosing to use primarily market growth assets.

6.4.2 Simplistic Risk Profiling and the resultant “pigeon holing” of a client are contrary to the concept of personalised advice.

6.4.3 A client’s risk tolerance self-assessment does not satisfy an adviser’s obligations to assess the client’s risk tolerance.

***Capital vs. Income Risk***

6.5 Investors may find it difficult to understand investment risk when it is explained in generalised terms. And they may take a different view about risk with different assets. They may be very concerned about risking any of the money they are saving to buy a house for example but be happy for all of their superannuation that is not accessible for twenty years to be subject to market risk.

6.6 In the short-term, even long-term investors may be more concerned about cash flow issues than in capital movements. They may be easily able to tolerate short-term reductions in capital but be unable to easily tolerate a drop in their income.

6.7 Best practice will include evaluating the downside risk to both capital and cash flow in the short-term and also over the period of investment. Advisers will consider the implications of poor performance on the financial well being of clients and advise the clients of these risks in term that are easily understood.

6.8 This will then provide the basis for advising the client about investment risk so that they can form a view about their attitude to the investment risk implicit in the recommendations.

**7. *SUMMARY OF FPA POSITION ON RISK TOLERANCE***

7.1 The FPA does not endorse any particular approach or product for assessing investment risk tolerance.

7.2 A financial planner’s role is not to ensure that clients avoid risk, but to educate and help clients embrace and manage reasonable investment risks in achieving desired financial goals over realistic time frames.

7.3 Financial planners must assess a client’s investment risk tolerance, and apply that assessment when formulating advice. This assessment is an integral

component of explaining the risks of the recommended strategy and to educating client's about investment risks.

7.4 Assessment of a client's tolerance to investment risk, should consider the tolerance of the client's volatility to income and capital fluctuations over the short and longer terms.

8. **NEXT STEP**

8.1 This Policy Position will be reviewed each 12 months of the effective issue date to ensure its continued relevance.

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**FPA CONTACT ON POLICY POSITION:**

**Please forward comments on this Policy Position to the**  
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